

A Study on the Subordination of Shareholder Claims in the Context of Bankruptcy

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Abstract: As bankruptcy cases continue to rise, the subordination of shareholder claims has attracted growing attention in the field of bankruptcy law. The subordination of shareholder claims refers to situations where claims held by shareholders are ranked below those of other creditors for repayment, due to their special status, controlling position, or inequitable conduct in bankruptcy proceedings. The fairness and transparency of bankruptcy liquidation are most at risk when shareholders abuse their privileged position and informational advantage to harm external creditors. In this paper, the exploration on the relevant theories and practices of the subordination of shareholder claims in the context of bankruptcy is conducted, with a focus on analyzing its current application status, legitimacy, and potential evolution in bankruptcy liquidation. By reviewing relevant literature, legal provisions, judicial interpretations, and typical cases, the paper summarizes key achievements and controversies in shareholder claim subordination research and analyzes the conditions for applying various liquidation models. The results show that the subordination of shareholder claims plays an important role in protecting creditors' interests and ensuring the fairness of bankruptcy proceedings. This paper further argues that, with the continuous development of bankruptcy law and judicial practice, the subordination regime is expected to play a more prominent and constructive role in the future.

Keywords: Subordination of shareholder claims, Bankruptcy liquidation, Priority of claims, Equitable subordination doctrine

1. Introduction

In the context of intensified market competition, bankruptcy has become a frequent occurrence in modern economies, where the allocation of debt repayment remains a core concern in proceedings. In bankruptcy proceedings, shareholders, as owners of the company, may also hold creditor claims, thus resulting in a dual status that renders the treatment of shareholder claims especially complex [1]. In bankruptcy liquidation, shareholders may use their control and access to information to prioritize their own claims, which can adversely affect the rights of external creditors. However, existing laws and regulations provide no clear rules regarding the repayment order of shareholder claims, resulting in a lack of uniform standards in practice and frequent disputes. The subordination of shareholder claims arises when shareholders, owing to their special status, controlling position, or inequitable behavior, are required to have their claims satisfied only after those of other creditors in bankruptcy cases. This has become a pressing issue in need of resolution [2]. Although some studies have

addressed the priority of shareholder claims in bankruptcy, the current legal framework still lacks systematic provisions on this matter, and practical mechanisms for resolving such disputes remain inadequate. This paper investigates the subordination of shareholder claims in bankruptcy liquidation, focusing on how to reasonably determine their priority and the challenges posed by the current legal framework. To this end, it combines literature review and case analysis to integrate academic insights and legal norms, aiming to support improvements in China's bankruptcy law and guide the handling of shareholder claims.

2. The subordination of shareholder claims in bankruptcy liquidation

2.1. The nature of shareholder claims and principles of bankruptcy liquidation

Under the background of bankruptcy liquidation, shareholder claims are significantly different from ordinary claims. As the company's owners, shareholders hold claims that are closely tied to corporate control and interests. However, in bankruptcy liquidation, these claims do not directly reflect a fair distribution of the liquidation burden. Instead, such claims may conflict with the interests of other creditors. Given the unique relationship between shareholders and the company, shareholder claims are distinct from typical debt or contractual claims [3]. The basic principles of bankruptcy liquidation, namely fairness, openness, and transparency, aim to protect the legitimate rights and interests of all creditors, with certain claims such as employee wages and tax obligations given priority. In contrast, shareholder claims are generally assigned a lower priority in the order of repayment [4]. However, the distinct nature of shareholder claims and their close relationship with the company make their treatment in bankruptcy more complex, potentially impacting the equitable distribution to other creditors.

2.2. The conflict between shareholder claims and external creditor interests

In bankruptcy proceedings, a significant issue that cannot be overlooked is reflected in the conflict of interests between shareholder claims and external creditors like banks and suppliers. By taking advantage of their control and access to information, shareholders may carry out actions such as related-party transactions or asset transfers, which can lead to the diversion of company assets and ultimately harm the interests of other creditors. In particular, external creditors may face losses due to shareholders using their control to prioritize their own repayment through improper means when a conflict arises between shareholder claims and the claims of external creditors. This is especially true when shareholder claims are positioned at a higher priority in the liquidation order, as ordinary creditors may not receive full repayment. Under this conflict, the legal and economic risks in the bankruptcy process are exacerbated, in which the fairness of bankruptcy liquidation is affected, leading to a weakening of creditor confidence in the bankruptcy system [5].

2.3. The legal framework and protective mechanisms of shareholder claim subordination

In order to resolve the conflict between shareholder claims and the interests of external creditors, the doctrine of shareholder claim subordination has gradually been introduced into bankruptcy law as a legal safeguard. At its core, this system treats shareholder claims as subordinated, placing them behind general creditor claims in the order of repayment [5]. Specifically, shareholder claims may only be satisfied after all other creditors, including both priority and ordinary creditors, have been fully repaid. The introduction of this system is grounded in key theoretical foundations, particularly the principles of fairness and the alignment of rights with responsibilities. In line with the principle of fairness, bankruptcy proceedings are expected to ensure equal treatment among creditors and to prevent undue advantage arising from special relationships or positions. As for the principle of

consistency of rights and responsibilities, shareholders, as investors in the company, are required to share risks with the company and that their claims should be ranked behind those of other creditors. The subordination of shareholder claims helps safeguard the interests of external creditors, ensures the fairness of bankruptcy proceedings, and prevents shareholders from leveraging their control or special status to disrupt equitable liquidation [6].

3. Legislative exploration and judicial practice of shareholder claim subordination

3.1. Legal recognition and legislative progress of shareholder claim subordination

In China's judicial practice, the subordination of shareholder claims was supported by a number of cases, but gaps remain in the legislative framework. At present, there is no clear statutory provision addressing the subordination of shareholder claims. However, analysis of relevant laws and judicial practice indicates that shareholder claims occupy a distinct position in bankruptcy distribution. In specific judicial practice, the subordination of shareholder claims is typically determined by courts based on factors such as whether shareholders have fulfilled their capital contribution obligations and whether there are unfair transactions. While shareholder claims are generally afforded equal status with those of external creditors in bankruptcy distribution, debt review procedures must exercise heightened scrutiny over such claims to guard against potential investment opportunism. This includes ensuring that shareholders have not attempted to circumvent capital contribution obligations through loans or engaged in conduct detrimental to external creditors [7].

The evolution of China's legislative exploration to the subordination of shareholder claims has shifted progressively from an "automatic subordination" model to an "equitable subordination" framework [8]. In 1999, in Article 16 of the *Regulations on Wholly State-Owned Enterprises in the Shenzhen Special Economic Zone*, the stipulation is made that the claims of the shareholders of a state-owned sole proprietorship company against the company should not be prioritized over those of other creditors of the company. In essence, this provision resembled the principle of automatic subordination and represented the first legislative attempt at introducing subordination in China. However, the regulation was declared invalid in 2010. Article 52 of the Draft Provisions on Several Issues Concerning the Trial of Company Dispute Cases (I), issued in 2003, proposed that, during bankruptcy liquidation of a subsidiary company, the claims of the controlling company should rank below those of the subsidiary's other creditors. Besides, attempts to apply the principle of equitable subordination were made in the 2005 revision of the Company Law, the 2006 promulgation of the Bankruptcy Law, and related judicial interpretations, but these efforts were not ultimately codified into written law. However, the principle has drawn great attention from relevant authorities [9]. For example, at the 2008 China Bankruptcy Law Forum, the Vice President of the Supreme People's Court called for further discussion on equitable subordination in affiliated company bankruptcies. In 2015, the Supreme People's Court published four typical cases, emphasizing the relevance of the equitable subordination principle, as illustrated in *Shagang Company v. Kaitian Company*. And this exploration is a strong response from China's judiciary to equitable subordination. Subsequently, courts in places such as Shanghai and Sichuan began to draw on and apply the principle of equitable subordination when handling bankruptcy-related creditor cases, gradually forming a certain judicial practice. In judicial practice, when controlling shareholders of the debtor engage in unfair actions that harm the debtor company's assets, preventing external creditors from receiving fair repayment, judges primarily rely on the principle of equitable subordination to adjust the repayment priority of such creditors, hence placing them after external creditors. The principle of equitable subordination requires judges to analyze each case based on the evidence presented, ensuring a fair balance in the order of creditor repayment. Meanwhile, China's judicial approach has shifted from the relatively lenient "automatic subordination" to a more cautious application of "equitable subordination" [10].

3.2. Disputes and conditions for the subordination of controlling shareholder claims

The issue of the subordination of controlling shareholder claims has sparked widespread discussion in academic circles, primarily focusing on the conditions for application and specific circumstances. From the perspective of the time element, this portion of the claim should not be subject to the equitable subordination principle if a claim against a bankrupt company is acquired by a controlling shareholder before becoming a controlling entity through fair and reasonable means. In other words, if a controlling shareholder is an external creditor and acquires claims in a fair manner, those claims should be treated equally with other creditors, without the need for subordination. Furthermore, the equitable subordination principle is mostly applied to controlling shareholders in judicial practice from the perspective of the subject element. The principle of equitable subordination in judicial practice mainly targets the claims of controlling shareholders whose abuse of control or excessive manipulation of company operations harms the interests of other creditors. It is applicable only when their misconduct like improper control or excessive manipulation harms ordinary creditors. If the controlling shareholder's actions do not negatively impact ordinary creditors, or if their claims are legitimate and reasonable, the principle should not be invoked.

Furthermore, regarding causality, there must be a causal relationship between the misconduct of the controlling entity in acquiring its claims and the harm caused to the ordinary creditors of the subordinate company. The principle of equitable subordination applies only when the controlling shareholder's misconduct directly harms the interests of ordinary creditors. Subordination should not be enforced if the controlling shareholder's actions do not interfere with the interests of other creditors, or if the claims are justifiable and proper. From a prerequisite perspective, the principle of equitable subordination should only be applied after all other legal remedies have been exhausted. If external creditors of the bankrupt company can protect their rights through other legal means under current Chinese law, courts should not directly apply the principle of equitable subordination. From an outcome perspective, the purpose of equitable subordination is to compensate for the harm suffered by creditors or minority shareholders, not to punish the controlling entity. Therefore, the subordination of the controlling entity's claims should be limited to what is necessary, avoiding excessive interference and ensuring a fair and reasonable order of debt repayment.

3.3. The impact of shareholder claims subordination on bankruptcy proceedings and legal improvement

In bankruptcy liquidation or reorganization, if shareholder claims are not subordinated, they may be paid before other ordinary creditors, which is clearly unfair. This is because shareholders typically have more control over the company's operations and bear limited liability. The subordination of shareholder claims helps to clarify the priority in debt repayment. In the distribution of bankruptcy assets, secured debts, employee claims, and tax debts should be settled first, followed by ordinary creditors, with shareholder claims ranked last. This arrangement prevents shareholders from using their advantageous position to harm other creditors' interests and ensures that ordinary creditors, especially unsecured creditors, have a fair chance of repayment. This approach upholds the fairness and credibility of the bankruptcy process, promotes greater caution among shareholders in their business practices, and minimizes the risk of actions that may harm creditors through excessive risk-taking. And the subordination of shareholder claims challenges the traditional notion of equal creditor treatment, prompting a reevaluation of the debt repayment order's fairness, especially in bankruptcy cases. This shift encourages further legal exploration of the interests and risks behind different claims, promoting a more precise balance of equity within the legal framework.

Moreover, clarifying the subordination of shareholder claims boosts bankruptcy law's protection of external creditors' rights, ensuring a more fair and equitable repayment process. By establishing

the subordination of shareholder claims, it can effectively restrain improper shareholder behavior, preventing actions like fabricating debts or withdrawing capital, which harm the company and other creditors. This not only upholds the fairness of bankruptcy procedures but also promotes the healthy development of the market economy. Besides, the subordination of shareholder claims contributes to the improvement of bankruptcy law and the protection of creditor interests, particularly those of external creditors. And it highlights the dynamic relationship between shareholders and external creditors, refining bankruptcy law's interest balance theory and providing strong theoretical support for resolving complex debt disputes and advancing legal studies. Defining the subordinate position of shareholder claims in bankruptcy helps increase shareholders' risk awareness, which encourages cautious decision-making and reduces excessive risk-taking or abuse of power [11]. The mechanism also promotes the improvement of corporate governance, requiring companies to establish more transparent financial and decision-making processes, thus reducing the possibility of shareholders transferring benefits through improper means [12]. Meanwhile, the subordination of shareholder claims ensures external creditors' priority repayment, protecting their interests, upholding fairness, and supporting the healthy development of the market economy.

4. Future outlook and reform path of the subordination of shareholder claims system

At present, it is generally agreed that shareholder claims should be subordinated to other creditors' claims, particularly for controlling shareholders. If their actions essentially constitute self-dealing, there is a high risk of transferring assets or seeking improper benefits through transactions with the company. More importantly, shareholders, due to their status, have the right to claim the company's residual value and exercise control. As compensation, shareholders should have a lower priority in debt repayment during the debtor's bankruptcy, to prevent them from receiving payment alongside ordinary creditors by attaching debt claims. This would undermine the shareholders' legal position and harm the interests of creditors. Though relevant legislation has not yet provided clear provisions, some tendencies toward subordinating shareholder claims below those of ordinary creditors can be observed in existing statutes and case law.

The debate on whether shareholder claims should be subordinated via equitable subordination or automatic subordination stems from early legislative practices. Although certain related regulations were later abolished, consensus has not yet been reached in practice regarding the subordination of shareholder claims. The current bankruptcy law and related judicial interpretations do not explicitly adopt the principle of equitable subordination, with judges instead relying more on the purpose of the law and fairness principles in their rulings. However, theoretical discussions often propose the introduction of equitable subordination to define the priority of shareholder claims. In practical terms, a unified rule for its application has yet to be established. Equitable subordination helps to fairly determine the debt repayment order when a debtor enters bankruptcy proceedings and is unable to repay all debts. The principle remains applicable, even though it is not explicitly defined in legislation, as it is supported by the civil law principles of fairness and good faith. Research on the specific elements of the subordinated shareholder claim model has examined its application through aspects such as timing, subject, behavior, causality, prerequisites, and outcomes. These studies primarily focus on preventing controlling shareholders from abusing their rights, leading to corporate personality confusion, engaging in unfair related-party transactions, or colluding with bankrupt companies to harm creditors' legitimate interests, hence protecting the rights of external creditors and optimizing the business environment. Thus, discussions on the legitimacy, application models, and criteria for subordinating shareholder claims provide a solid theoretical foundation for establishing subordinated rules in bankruptcy law and judicial decisions. These debates also offer valuable insights for analyzing specific issues and formulating effective countermeasures.

5. Conclusion

This paper investigates the theory and practice of shareholder claim subordination in bankruptcy proceedings, highlighting that shareholders, due to their unique status and control, may harm the interests of external creditors during debt repayment in bankruptcy. Thus, to balance the interests of all parties and ensure fairness and transparency in the repayment process, shareholder claims must be subordinated to those of creditors. Through a review of literature and case analysis, this study reveals the application and effects of shareholder claim subordination in bankruptcy law practice. It also explores multiple factors influencing the effectiveness of the shareholder claim subordination system, including company ownership structure, governance mechanisms, pre-bankruptcy business conduct, and the level of development of laws and regulations.

Though this study has made some progress in exploring the subordination of shareholder claims, there are still several limitations. Given the complexity of the legal relationships and the need to balance multiple interests involved in the shareholder claim subordination system, theoretical discussions remain insufficient and require further development. Additionally, while specific policy recommendations have been proposed, the feasibility and effectiveness of these suggestions in practical implementation have not been fully addressed. Therefore, future research could expand and deepen case analyses, covering a broader range of representative industries and company types, particularly focusing on bankruptcy practices in emerging industries and multinational corporations to reveal the applicability of shareholder claim subordination in different contexts. Furthermore, empirical research should be strengthened to gather firsthand data and test the feasibility and effectiveness of the theoretical assumptions and policy recommendations. It is also important to enhance communication and collaboration with judicial practitioners to gain deeper insights into the challenges and issues encountered during the implementation of the system and to offer more targeted and practical countermeasures. Future research should focus on international bankruptcy law developments, drawing on established legal practices to enhance China's bankruptcy law.

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